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Harvey Bale

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INVESTMENT FRICTIONS AND OPPORTUNITIES IN BILATERAL U.S.-CANADIAN TRADE RELATIONS

Harvey Bale, Jr.
Office of the U.S. Trade Representative
Washington, D.C.

This paper contains preliminary findings from research still in progress and should not be quoted without prior approval of the author.

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DEPARTMENT OF ECONOMICS
UNIVERSITY OF WESTERN ONTARIO
LONDON, CANADA
N6A 5C2

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Introduction: U.S. and Canadian Statements of Investment Policies

In 1980, a major dispute erupted between Canada and the United States concerning aspects of Canada's foreign investment policies. Bilateral relations have since improved as both sides responded to the task of trying to maintain and strengthen an economic relationship which has been larger and more durable than that between any two countries elsewhere in the world. Nevertheless, policy differences over investment issues remain, and will likely remain for the foreseeable future. This paper reviews U.S.-Canadian investment policy differences and examines possible future developments affecting them.

The governments of both Canada and the United States have recently issued statements on international economic policy relevant to the topic of this paper. In August, the Government of Canada issued two "discussion papers" on its trade and investment policies; independently, less than two weeks later, the United States issued a new investment policy statement. These statements serve to clarify and highlight the nature of some of the major recent bilateral investment policy disagreements and some of the difficulties that could recur in the future. The Canadian discussion papers (Canadian Trade Policy for the 1980's and

A Review of Canadian Trade Policy) extensively review the Canadian government's attitude toward foreign direct investment. In A Review of Canadian Trade Policy, Canada's investment policy is declared to be generally one of "non-intervention in the investment process" (p. 42). Exceptions to this rule include: (1) the use of incentives to promote regional development, attract new industry, strengthen international competitiveness and stimulate structural adjustment; (2) the Foreign Investment Review Act of 1973 and the National Energy Program of 1980, adopted to respond to Canadians' concerns about the large degree of foreign ownership of domestic assets; and (3) the use of the 1973 Act as a way to screen foreign investments to ensure "significant benefits" to Canada (pp. 42-3). Concerning the last point, it is argued that foreign investment may be less desirable since multinationals may organize operations that "may conflict with the attainment of national objectives" and that subsidiaries may be subject to home-country laws including export controls and antitrust laws (p. 44). Thus, use of the 1973 Act is made to both screen investments and to negotiate additional benefits for Canada.

In September, the White House released its "International Investment Policy Statement," updating the last such document issued by the Carter Administration in 1977. It articulates the policy view the Reagan Administration has operated under since 1981. Like that of the previous Administration, the new statement reflects a traditional liberal attitude toward foreign investment; however, it also reflects a significant shift in emphasis from the previous statement. The Carter Administration stated that its fundamental investment policy was "neither to promote nor to discourage inward and outward investment flows." It also stated that while the U.S. government should seek national treatment of firms once they are established, it should not "intervene" with respect to any international investment activities of companies (National Advisory Council 1977). The underlying thesis of the 1977 statement became known as the "investment neutrality doctrine," and has been criticized severely by most business groups which hold that U.S. investment overseas serves U.S. economic interests (Business Roundtable 1983). The September 1983 statement, in contrast, articulated the Reagan Administration's view that international investment flows should generally be subject only to "market forces," and that both home and host countries gain from investment flows that operate according to these forces. Thus, the United States is opposed to domestic and foreign government policies that "impede or distort investment" or seek to "shift artificially the benefits" of investment flows, including performance requirements, incentives and discriminatory treatment of foreign investors. The statement also commits the United States to work to reduce or eliminate "unreasonable and discriminatory barriers to entry of investment" (White House 1983).

The new U.S. statement also reflects the recent evolution of the United States as a major host country to foreign investment. Between 1977 and 1982, foreign direct investment in the United States increased from $34.6 billion to $101.8 billion (Whichard 1963). U.S. policy toward inward direct investment is to provide "fair, equitable and non-discriminatory treatment" with exceptions to such treatment "only as necessary to protect our security and related interests consistent with international legal obligations" (Ibid., 1983). The assumptions underlying the U.S. position on foreign direct investment flows are: first, market-responsive direct investment flows to and from the United States increase the efficiency of the use of capital and technology, benefiting both home and host countries; second, U.S. investment abroad enhances U.S. trade opportunities through a greater U.S. business presence abroad and the positive macroeconomic effect of such investment flows on foreign incomes and overall foreign imports.

Both the Canadian and American statements assert respective liberal policies toward inward flows of foreign direct investment. Nevertheless, these two statements represent quite different attitudes on foreign investment issues. Canadian policy reflects a continuing fundamental concern about foreign ownership and whether foreign investment generally provides "significant benefits" to Canada. On the other hand, the U.S. policy view presumes that inward foreign direct investment is beneficial. Indeed, most of the U.S. policy attention is directed at problems of U.S. direct investment activity abroad. I have not heard Canadian policy officials express themselves on conditions affecting the treatment of Canadian investment in foreign countries (except with regard to the "unitary tax" in the United States). Despite Canada's growing direct investment position abroad (with net outward flows since 1974 -- becoming quite substantial after 1977), Canada's overall investment policies reflect the viewpoint of a capital-importing country. It sets in contraposition the interests of capital exporting and importing countries. Indeed, Canadian policymakers express the view that (reflective of "divergent national interests") U.S. and Canadian investment policies "are likely to remain in conflict throughout the 1980's and beyond" (A Review, p. 208). Canada's Ambassador to Washington has elaborated on this conflict in a recent paper, stating:

> Capital exporting countries which derive economic benefit from investment abroad *want* the freest possible international regime. Conversely, capital importing economies need to balance their need for capital with their *need* for a proper measure of national economic control (Gotlieb 1982, italics added).

Canada and the United States continue to maintain substantially different policy views on the role of government intervention generally, and in foreign direct investment flows (Malmgren

and Drouin 1981-82). Of course, in the absence of multilateral or bilateral agreements on direct investment issues which would provide for a common set of objectives, policy differences on investment issues exist not only between the United States and Canada but also multilaterally, particularly between most OECD countries and the developing countries. Of greater importance, however, is how policy differences between our two countries are managed in the absence of a multilateral framework. Lacking it, we have to look to bilateral processes. (While the United States and Canada are members of the OECD which has codes relating to direct investment issues, the OECD does not provide a very satisfactory international framework because its enforcement mechanisms are very weak; further, Canada is not a signatory to one of the codes, the 1961 Capital Movements Code.) It is the U.S. view that it is in the mutual interest of Canada and the United States to work together toward new agreements and forms of economic cooperation and liberalization in the investment area -- not only in our bilateral relationship but also multilaterally. We also wish to see a better international understanding of how investment policies may have an impact on existing international agreements covering other activities, such as the GATT system of trade.

U.S. Attitudes Towards the Investment Policies of Canada

Canadians are sensitive to recent private and public U.S. views expressed on Canada's investment policies. It is frequently asserted that we in the U.S. government seem to be singling out Canada's investment policies for special attention and criticism, ignoring restrictions of other countries and demonstrating a lack of appreciation for the economic policies frequently adopted by Canada that are different than those preferred in the United States. Actually, we do not discriminate toward Canada in urging the adoption abroad of fewer restrictions on direct investment flows; in this respect, we follow the most-favored-nation policy -- i.e., working toward more liberal investment policies globally.

Underscoring the emphasis given by the United States to liberalizing foreign direct investment flows are the large number of bilateral agreements, in the form of treaties, that contain direct investment provisions. Typically, these treaties (formerly called friendship, commerce and navigation (FCN) treaties and, now, bilateral investment treaties) provide that governments should accord national treatment to business activities including the organization and acquisition of companies by nationals and companies from the other country. (They also address the issues of expropriation and business transfers of funds.) The treaties, nevertheless, allow each country to reserve the right to restrict the activities of foreign nationals or companies in certain sectors. Normally, sectors that may be reserved are those which many countries consider to be sensitive or related to national security concerns, including: communications, air and water transport, banking, natural resources

and the ownership of real estate. Actual restrictions may be only minimal, permitting significant foreign investment. In the United States, for example, there is substantial foreign direct investment in the banking, energy and real estate sectors. Moreover, these derogations from national treatment are tempered by a provision requiring that restrictions or discrimination put into effect by either country in these sectors shall <u>not</u> apply to foreign investments existing <u>before</u> the new measures are enacted (Sullivan 1980; USTR 1983 (b)). Thus, exceptions to national treatment in these treaties are few, and investments are "grandfathered" against new restrictions or discrimination policies implemented after investments are made.

The United States has signed treaties of this type with most of the major OECD countries and with a number of developing countries, including Pakistan, Korea, Egypt, Panama, Taiwan and Thailand. In our agreements with developed countries, no general investment screening mechanisms are permitted. On the other hand, investment screening is not inconsistent with treaty provisions in some of our agreements with developing countries.

This discussion of bilateral investment treaties is intended to demonstrate that the posture that the United States has presented to Canada has also been put forward to other U.S. investment partners. In addition to bilateral treaties, the United States has also joined other OECD countries (including Canada) in the

1976 Declaration on International Investment and Multinational Enterprises. The Declaration provides that, allowing for the protection of national security, OECD countries should provide national treatment to foreign companies operating in their territories and owned by nationals of other member countries (OECD 1976). Unlike U.S. bilateral agreements with a number of developed countries, the 1976 Declaration allows generally for the screening of foreign investment by any country; once permitted, however, such investments are to be treated no less favorably than investments carried out by a country's nationals. New derogations from the national treatment Declaration (e.g., Canada's National Energy Program) are subject to multilateral review in the OECD Committee on Investment and Multinational Enterprises, but not to sanctions within that framework.

While the United States approach to addressing investment restrictions is global, U.S. concerns about Canada's policies reflect the substantial trade and investment commitment the United States has in Canada.

Canada's Foreign Investment Review Act

Until 1973, the United States and Canada pursued generally similar policies with respect to inward foreign direct investment. Neither country generally screened foreign investments unless such investments were proposed in certain sensitive or "key

sectors." Some of the major sectoral restrictions in the United States were noted above. Limitations on foreign ownership had existed in a number of the corresponding sectors in Canada -- viz., air, rail and water transport; broadcasting; insurance, banking and trust companies; securities firms; and certain mining activities on public lands (Franck 1976). A major additional step taken to respond to the political and economic arguments to limit the growth of foreign-owned or controlled investments in Canada was the enactment of the 1973 Foreign Investment Review Act (FIRA) and the establishment of the Foreign Investment Review Agency. The FIRA requires the Canadian government to permit the foreign acquisition of Canadian enterprises or establishment of new businesses only if they individually result in "significant benefit" to Canada. The significant-benefit criteria outlined in the FIRA for evaluating any foreign investment cover: (1) the impact on economic variables such as employment, resource processing, exports and the use of Canadian "parts, components and services"; (2) the degree of "participation" by Canadians in the proposed enterprise and the industry in which the enterprise would operate; (3) the effect on productivity and innovation and product variety in Canada; (4) the effect on competition in Canada; and (5) the compatibility of the proposal with national and provincial economic and industrial policy objectives (FIR Act 1973).

The FIRA constitutes a substantially different approach to inward direct investment than U.S. policy. In addition to the key-sector restrictions, which are also applied in the United States, the FIRA imposes a general foreign screening process on acquisitions, new establishments and expansion into new business fields by foreign-controlled enterprises already operating in Canada. The Canadian government has stated that the FIRA is a political response to excessive foreign ownership in Canada. Notwithstanding this, the government has also indicated that it is not the purpose of the FIRA "to discourage or prevent foreign investment," but to ensure beneficial foreign investment (A Review, op.cit.). Canadian officials have stated that Canada welcomes foreign investment, noting that over the life of the FIRA, only 10 percent of the foreign investment applications have been rejected. And the rejection rate appears to have declined since mid-1982 when a change was made in the leadership of the Foreign Investment Review Agency and the Ministry of Industry, Trade and Commerce and new procedures were implemented designed to "streamline" the review process.

Having a low rejection rate for foreign investment applications, of course, does not signify that the FIRA has not had a negative effect on foreign investments. Many applications have been withdrawn and an unknown volume of investments have never been proposed because of the uncertainties involved in dealing with the Canadian government; or, in some cases, because of the perception that foreign investment proposals will be denied when, for example,

they would introduce new competition for locally-owned firms.

It is widely known among foreign investors that there is complete discretion by the Canadian government in the application of the significant-benefits criteria mentioned above to a given investment proposal. The Canadian government has resisted clearly articulating how the criteria should be applied on an industry sector basis (Gray to Fraser, 1982). There are no guidelines to understanding the relative significance that is to be attached to the criteria (Businessman's Guide n.d.).

Because of the cost and uncertainty of the FIRA process, many American businessmen believe that it is a substantial impediment to foreign investment in Canada (LeMay 1983). The trend of direct investment in Canada since 1974 suggests that the FIRA has had some impact on preventing foreign investment in Canada. Table 1 presents statistics on inward and outward foreign direct investment flows of Canada since 1960. Since 1973 Canada has been a net exporter of direct investment capital; further, even in nominal terms, it has experienced reduced inward direct investment flows since 1974 compared to the period 1960-73.

Furthermore, Table 2 indicates that the share of total U.S. direct investment abroad going to Canada has declined substantially since 1974. Table 3 shows that reinvested earnings of U.S. firms have accounted for practically all U.S. direct investment there since 1973. Earnings reinvested by foreign affiliates in the same line of business activities are not reviewable under the FIRA. While other factors (including recent fluctuations in Canadian and worldwide economic growth, the National Energy Program and previous political uncertainties about the status of Quebec) may also have been significant factors, it appears that the FIRA has had a significant effect on flows of offshore direct investment funds to Canada.

The process of investment screening has been an important source of irritation to U.S. businessmen and officials in the United States. Although it is conceded that Canada is violating no international rules by the screening of investments, it is viewed as a protectionist process in the trade, as well as investment contexts.

One of the FIRA's significant-benefits criteria is the effect that a foreign investment proposal has on competition within Canada. The beneficial impact of competition has been frequently cited as a factor in the acceptance of foreign investment proposals (Morici et al., p. 42). Nevertheless, the FIRA process invites the possibility that domestic Canadian firms may lobby the government to block a given foreign investment proposal. U.S. officials have heard American firms cite circumstances of this practice, but it is impossible to estimate the full extent to which FIRA

blocks foreign investments in order to protect local firms. Recently, there have been circumstances in which U.S. firms in Canada have been the object of "unfriendly" acquisitions, such as those in 1981 involving U.S. energy companies. U.S. companies have argued that a frequently-used business tactic to discourage such takeover attempts -- viz., a counter-acquisition proposal -- is impossible when the acquiring company is Canadian.

The existence of FIRA as a factor preventing a counter-takeover proposal, at the time Canadian firms were bidding for Conoco and Cities Service in 1980 and 1981, fueled efforts in the Congress to pass legislation barring Canadian acquisitions of U.S. energy companies (Fortune 1981). However, these pressures eased as the burden of rising interest rates increased the cost of acquisition and the Canadian government, in order to defend the Canadian dollar, put pressure on Canadian banks to avoid making loans for such acquisitions. However, the acquisition issue remains a potentially serious problem so long as there is a possibility of future numerous Canadian takeover attempts. Of course, there is an argument, so far prevailing in the United States, that we should not in the least way object to Canadian acquisitions of U.S. companies; nevertheless, there is a strong feeling of frustration in the U.S. business community that sometimes leads to proposals for reciprocal actions against Canadian and other countries' investment screening policies.

Another problem in U.S.-Canadian relations concerning the FIRA relates to acquisitions which concern Canadian companies only through an existing subsidiary relationship. In 1975, the Dow Jones corporation acquired an American book publisher holding a Canadian subsidiary (Irwin-Dorsey). The Canadian government reviewed the Dow Jones acquisition of Irwin Dorsey and decided that the acquisition had no significant benefit for Canada and disallowed it. And in 1981, the government also disallowed the transfer of ownership of Stange Canada from its prior American food-processing parent to another American firm, McCormick and Company.

In these cases and in others, the responsible Canadian officials usually have offered no explanation for the transfer disallowances. More importantly, it disturbs U.S. businessmen and government officials that the FIRA process reaches out to affect "extra-territorial" transfers between two foreign companies. A legitimate reason (in the U.S. view) for a FIRA review in this circumstance would be to check for possible criminal records of the directors of the acquiring company. However, it appears that two other objectives predominate: first, to "Canadianize" by means of forced divestiture of the Canadian subsidiary; and, second, to take the opportunity to seek commitment from the acquiring company to offer new "benefits" to Canada. A FIRA case concerning Gannett, an American newspaper publishing company, illustrates the second objective. Gannett's acquisition of Mediacom Industries

of Toronto, obtained when Gannett acquired another American company, was approved by Canada only after a series of export, local purchase, technology and financial commitments were made by Gannett.

The Gannett case raises the additional issue important to the United States: i.e, the nature of commitments made by foreign companies to the Canadian government under the FIRA review process. The lack of confidence on the part of the Canadian government that foreign direct investment in Canada will bring significant benefits to Canada has already been noted; thus, "understandings" by companies to carry out in Canada R&D expenditures, local sourcing, exporting and encouraging Canadian participation in ownership and management are heavily weighed in the FIRA approval process. In more than 2,600 foreign investment proposals approved under the FIRA process through early 1982, more than 60 percent of the cases involved commitments to increased processing or use of Canadian goods and services, 5 percent to Canadian participation, 37 percent to increased exports and 21 percent to technological development (Morici, et al., p. 42). The high incidence of local-sourcing commitments reflects an emphasis given by the Canadian government to the development of indigenous suppliers of manufactured parts and service operations and to affect the alleged tendency of foreign companies to import rather than develop local sources. The Canadian government has often used its "bargaining power" to "negotiate commitments" including those on research and development expenditures, local sourcing, exports and Canadian participation in management. The outcome of a FIRA review of a recent Apple Computer Company investment negotiation is reprinted below as an example of the use of its bargaining power government under the Foreign Investment Review Act to negotiate performance requirements.

> The Honorable Herb Gray, then Minister of Industry, Trade and Commerce, announced that on September 21, 1981 Apple Inc. of California made the following undertakings prior to receiving FIRA approval of its investment application:
>
> (1) to make all officers, except the Chairman of the Board and the Secretary, and all management resident Canadians.
>
> (2) to limit appointments of nonresidents to one year or less;
>
> (3) to sell at least 80 percent of its product through independent Canadian retailers (unless market conditions require the use of company personnel to make direct sales);
>
> (4) to perform in Canada at least 20 percent of all repair and maintenance service for products manufactured by the applicant or the new business and sold in Canada;
>
> (5) to seek actively and recommend to customers Canadian sources of compatible peripherals and materials subject to availability in sufficient quantities.
>
> (6) to commence manufacturing in Canada when sales justify establishment of a "module" employing approximately 100 people (anticipated within three years), and to review RPT progress toward this goal with the Department of Industry, Trade and Commerce twice a year.
>
> (7) to implement vigorously an existing agreement providing for the use of telidon interface kits (TIKs) dedicating Apple and its subsidiaries to the creation of a world market for TIKs.
>
> (8) to seek actively and develop Canadian sources for Canadian-made goods if competitively available (specifically power supply units and semi-conductor memories) ("For such purposes, complete information will be provided to Canadian suppliers regarding future worldwide requirements of the applicant, industry prices, and technology which the applicant is not restricted from communicating by previous agreements with third parties and which, in the judgment of the applicant, is required by such suppliers.");
>
> (9) to establish a corporate purchasing task force with the specific mandate of identifying and developing Canadian sources of supply for Apple's worldwide requirements;
>
> (10) to recommend to its worldwide dealers Canadian-made peripheral equipment, provided such products are competitive in price, performance and availability;
>
> (11) to ensure that at the end of the first year Canadian value added (CVA) will not be less than 38 percent of the cost of goods sold in Canada, and thereafter to make best efforts to achieve the highest level of CVA in accordance with the schedule (not available because of FIRA's secrecy regulations) submitted to FIRA by the applicant;
>
> (12) to establish within one year a Canadian software research and development group, and
>
> (13) to make best efforts to initiate R&D projects related to hardware.

Reprinted from Morici, et al., page 43.

The breadth of commitments that foreign investors make, as illustrated by the Apple example, is striking. It should be noted that some of the performance commitments made by Apple are "best efforts" or are conditioned on the appropriate economic circumstances (i.e., in undertaking (8) "to seek actively to develop Canadian sources for Canadian-made goods if competitively available");

however, under the follow-up procedures of the FIRA, Apple will be called upon to justify noncompliance even for best-efforts commitments in periodic governmental reviews of Apple's performance.

In other cases, the FIRA-review process has produced specific local content commitments which are not qualified by references to competitive or economic availability or domestic products. An example is Apple's commitment (11) to ensure a 38% minimum Canadian value-added in its cost structure. In another case, a U.S. machine builder that established a business in Canada in 1982 committed itself "to specify, to its Canadian subcontractors, that only Canadian steel, hydraulic and pneumatic devices and all other components be used" (FIR Agency, May 7, 1982). Also, a large U.S. retail toy chain committed "to purchase merchandise manufactured in Canada equal to 55 percent of the value of all merchandise purchases of the Canadian business, during the first two years of operations, increasing to 65 percent of the value of such purchases, during the third and succeeding years." In making the announcement of this case, the government stated that the toy company will "purchase significantly higher levels of Canadian-produced goods than does the Canadian toy retailing industry as a whole" (FIR Agency, October 4, 1982).

All segments of the American economy -- business, labor and government -- consider the issue of foreign performance requirements as another serious trade and investment distorting practice (LICIT 1981; Senate Hearings 1981). U.S. business interests are most concerned about foreign equity participation, local content, R&D and management control requirements. U.S. labor interests are concerned most about the domestic job effects of foreign export requirements. The U.S. government is concerned that these practices are expressions of protectionist pressures, distort trade and investment flows, may violate international agreements, and may lead eventually to U.S. mirroring such policies or even to direct retaliation, both responses generating a downward drift in world trade and investment flows.

Canada, of course, is not the only country that imposes such "performance requirements." A number of other countries also use such requirements as a condition for approval of foreign investments or the granting of financial investment incentives. As Table 4 indicates, most of these countries are developing countries. For these countries, as for Canada, local content requirements are the most common form of investment performance requirement.

A special cause of concern about Canada's use of such practices is that it is the largest trade and investment partner of the United States and is one of the more important developed country members of the OECD and the GATT. Thus, Canada's policies could harm U.S. interests bilaterally and (by example to other countries)

worldwide. Furthermore, we believe that certain types of Canada's performance commitment policy -- i.e., local content and export requirements -- violate international trade rules established under the GATT. Our concern about these measures (which some interest groups in the United States would like to see adopted for the domestic automobile industry) has been great enough for us to lodge a complaint in the GATT. There, in Geneva, a panel formed to adjudicate the dispute has made a recommendation to the Council of the GATT. That recommendation will be dealt with this fall.

U.S. government officials have often heard and read about the arguments put forward to justify the FIRA-based negotiation or performance commitments from foreign investors. They range from too little R&D spending in Canada to too many imports; from the creation of operations in Canada that are not globally competitive to the lack of Canadian participation in management. We also note that Canadian critics of some of these measures argue that the attention in Ottawa on the behavior of multinational enterprises in Canada is at least somewhat misdirected. For example, that R&D spending in Canada is very low relative to GNP compared with levels in other OECD countries; thus, foreign investors often have higher levels of R&D spending in Canada than do locally-owned companies. And the problem of trade competitiveness is probably related far more to trade barriers in Canada's foreign markets than to the trade patterns of foreign subsidiaries in Canada (Wonnacott and Wonnacott 1980).

On the other side, to some considerable extent, the negotiations between the government and investors under FIRA have been conditioned by market realities. Also, some of the publicly announced commitments address what the foreign investors may have done, more or less, anyway. Representatives of U.S. companies tell me that it is good corporate policy to try to carry out some of the local-sourcing and other activities sought by Canada in the FIRA process in most host countries in which they invest. Nevertheless, according to one Canadian businessman, the officials responsible for FIRA's administration have in recent years been "out for all they can get" in investor commitments (Wall Street Journal Sept. 25, 1981). As a result, the perceived costs and uncertainties for potential foreign investors increased at a time when global recession reduced the overall confidence of investors worldwide. The plan to review retroactively the performance of all foreign firms operating in Canada, announced in 1980, (and then withdrawn in 1981) heightened uncertainties and criticisms abroad of Canada's policies, and resulted in further pressure on the U.S. government to "do something" about Canada's policies in the investment and energy areas.

Recently, efforts have been made in Canada to reduce the procedural burden of the FIRA review process. American officials are hearing fewer complaints about the FIRA process in Canada. The improved

FIRA implementation process in Canada reflects a growing worldwide trend toward the greater recognition that private direct investment flows are an essential element promoting economic development and adjustment in a rapidly changing world economy.

Occasionally, we do hear complaints about sought-after "undertakings" or screening restrictions; the U.S. government is hopeful that we could work together to develop better multilateral or bilateral understandings concerning this issue.

The National Energy Program (NEP)

Canada's plan to broaden the scope of the FIRA to cover the review of existing foreign firms in 1980 was followed later that year by the announcement of the details of Canada's National Energy Program (NEP).

The basic objectives of the NEP are to enhance Canada's energy security, increase the share of the petroleum and gas sector held by the Canadian government, and to achieve Canadianization of the energy sector (with a goal of 50% Canadian ownership) by 1990. U.S. objections to the NEP have been largely directed at Canada's methods adopted to accomplish the last objective. The major objections include:

1) the introduction of a system of incentives for oil and

natural gas exploration based upon the degree of Canadian ownership and control of the exploration company. Under the Petroleum Incentives Program (PIP) up to 80 percent of exploration expenditures can be paid to companies with 65 percent Canadian ownership, with the ownership requirements varying up to 75 percent by 1986. (Foreign-owned and controlled corporations are eligible for grants covering 25 percent of expenses.) Notwithstanding Canadian concerns about the degree of foreign control of its domestic energy industry (59 percent of assets in 1980), this discriminating policy runs counter to the 1976 OECD Declaration that obliges member countries to provide national treatment to foreign enterprises "operating in their territories." Exceptions to this obligation are permitted to maintain public order or to meet national security or international peace commitments; however, placing foreign firms at a competitive disadvantage is not sanctioned for the purpose of "localization" of existing companies.

2) the claim to a 25 percent "Crown share" of exploration and production leased rights held on federal lands, applied retroactively and without adequate compensation. Limited "ex gratia" payments were authorized by Canadian legislation to compensate for the cost of drilling wells that lead to significant discoveries of oil or gas; but the Canadian government has indicated that the payments are not intended

to represent compensation for the Crown share. The "Crown-share" policy does not discriminate against foreign-owned companies. Both Canadian and foreign-owned companies have claimed that the "ex gratia" payments do not cover either the value of the share taken by the government or the costs incurred in the past in drilling wells that did not yield oil or gas. Estimates are that the payments represent less than 5 percent of the value of the Crown interest taken on the major federally-owned oil fields (Canadian Senate Debates, December 15, 1981).

3) COGLA administration: pressures on Canadian government-owned oil and gas lands to purchase domestic goods and services. While the Canadian government contends that its policy is designed "only" to encourage open bidding and Canadian opportunities to sell to large energy projects, the administrators of this policy appear to force companies to justify use of imported items.

These NEP measures, coupled with a 50 percent Canadian-ownership requirement for future leases on Canada federal lands, led to demands from segments of the U.S., European and private sector for "reciprocal" denial of access to U.S. federal minerals leases under the Mineral Lands Leasing Act of 1920. However, the U.S. government determined in early 1982 that Canada was reciprocal under the meaning of that Act. This determination was made on both legal and investment policy grounds. To deny Canadians energy investment opportunities in the United States would have slowed the rapid movement of drilling rigs from Canada to the United States in 1980 and 1981. Canada's energy policy, ostensibly designed to enhance its energy security, actually has contributed to U.S. energy development and production.

Notwithstanding the U.S. government's decision to declare Canada reciprocal under the MLLA, the decision in no way reflected a modification of the U.S. government's critical attitude toward aspects of the NEP and the FIRA (which is used to implement the NEP's policy on 50 percent Canadian ownership of corporations operating on Canada lands). The U.S. Interior Department, responsible for administration of the MLLA, noted in its press release of February 3, 1982, that

> Secretary Watt's determination was based strictly on an interpretation of the reciprocity provision of the MLLA....[However] The Administration continues to be seriously disturbed by Canada's discriminatory investment policies, embodied in the National Energy Program and in the operations of the Foreign Investment Review Agency (FIRA).

The response in the United States to the FIRA and NEP has included proposals from various quarters to: retaliate against the actions taken by Canada, tighten U.S. securities laws, block Canadian investment in U.S. energy companies, enact an American version of the FIRA, etc. They also fueled the calls for reciprocity legislation now being considered by the U.S. Congress.

United States Investment Policy

The negative U.S. reaction to Canada's FIRA and NEP has followed from the basic U.S. viewpoint on investment policy, reflected in the recent investment policy statement of the Administration. The United States is dedicated to working toward the reduction of barriers to foreign direct investment flows, the strengthening of the principle of national treatment and maintaining an international commitment to prompt and adequate compensation in the event of expropriation. But what it sees in its largest trade and investment partner is the tightening of the conditions placed on foreign investment in recent years; it sees, in the NEP, new discrimination against existing foreign investors, contrary to obligations entered into in the OECD; it also sees a failure to compensate investors, foreign as well as domestic, for a governmental taking of property through the Crown-share (or back-in) provision of the NEP.

Canadians have countered U.S. criticisms of Canada's investment and related energy policies. They have argued that the United States has as many barriers, or more, to foreign investment as does Canada (FIRA, Regan, Patterson). Minister of State for International Trade Gerald Regan has argued:

> The diffuse approach of most other industrial countries compared with the more comprehensive administrative

> system in Canada reflects a distinction more of form than of substance with little difference in the impact or restrictive effect upon incoming foreign direct investment. For example, while the US is relatively open in terms of foreign investment, there are a number of sectors where foreign control is prohibited or regulated....Apart from outright prohibitions, the US also has indirect controls on foreign investment including anti-trust laws, congressional lobbying, and monitoring bodies such as the Committee on Foreign Investment.

The author has noted above and elsewhere the sectors in the United States that are restricted to foreign investors (Bale 1983). With regard to lobbying of the Congress, this is an area that is fair game open to everyone, including Canadians and their local Washington representatives (both private and official). But I know of no recent significant cases of lobbying being effective in getting Congress to act to prevent foreign investments.

Frankly, I am puzzled by the assertion of the importance of the effect of U.S. antitrust laws on foreign investment in the United States. I know that they are sometimes cited as a barrier to such investment. However, as Canadians will be first to declare, no society grants an unqualified "right of establishment" to enterprises, foreign or domestic. The U.S. issue regarding foreign investment is whether there is international discrimination, or lack of national treatment. In this respect we strongly believe that U.S. antitrust laws are no more a burden on foreign enterprises than they are on domestic ones. It may have been true that antitrust enforcement authorities were excessively

hostile at various times in the past to acquisitions and mergers generally, leading to a view among some observers that U.S. antitrust policy and, specifically, the doctrine of "potential competition" was a tool to bar foreign investment in the United States. Recent court cases and the development of new antitrust guidelines by the U.S. Justice Department, however, strongly suggest "far less enthusiasm for the potential competition doctrine" (Floyd 1983).

This brings me last and, indeed, least to the Committee on Foreign Investment in the United States (CFIUS). I have discussed this, too, more fully elsewhere (Bale, op.cit.) but American officials have been bemused in hearing comparisons made between the FIRA process and the CFIUS. The only two points to be made about CFIUS are (1) its objective in recent years is to look at how the national interest is affected by investments in the United States by government-owned foreign enterprises (e.g., BP, Elf-Aquitaine, CDC, Kuwait Petroleum Company); and (2) it is the product of an Executive Order, having no vested authority to do anything to bar any foreign investments. It exists basically as an advisory body to the President and the various executive departments; while some consideration has been given recently to vesting certain authority in the CFIUS to deal with investments by government-owned enterprises, a specific plan of action has not been developed. Many are fearful in our country that giving any government body any authority to screen investments might lead eventually to the enactment of a U.S. FIRA.

If, indeed, U.S. investment policy were as restrictive as some Canadians claim, one would be totally confounded as to why and how foreign investors have been so plentifully and successfully investing in the United States in recent years, compared to their activities in some other countries. Tables 5 and 6 show, respectively, the growing importance of the United States as a host country to foreign investment, both in absolute terms (Table 5) and relative to other OECD countries (Table 6). Many foreign investors view the United States as a very tough and competitive market to enter. Nevertheless, even in the sectors of insurance, banking, real estate and mining where some states have laws that place some conditions or limits on foreign investment, the foreign presence in the United States is high. For example, most of the ten largest banks in California are foreign-owned, and Canadian real estate companies have invested heavily throughout the United States. While not yet reaching the same proportions in Canada, foreign investment is becoming a significant element in the U.S. economy. In 1980, foreign direct investors controlled 9 percent of total U.S. assets in the U.S. mining, manufacturing, petroleum and trade sectors. Foreign control was 15 percent of U.S. assets in wholesale trade, 7 percent in manufacturing, 18 percent in chemicals, 13 percent in stone, clay and glass and 9 percent in electronic equipment. In addition, foreigners controlled $44.1 billion in U.S. petroleum and coal industry

assets (Belli 1983). Indeed, it is the world business community that has provided the primary evidence on the issue of the relative absence of investment restrictions in the United States. They have made their evaluation using their Canadian dollars, yen, Deutsche marks, etc.

Nevertheless, U.S. policymakers at the federal and state level cannot remain complacent. Inward foreign direct investment is becoming a welcome source of much needed capital to assist the United States in its adjustment to changing world competitive conditions, and we need to be attentive to developments that may dampen the future growth in the level of inward direct capital flows. For example, fourteen states have in place some form of "unitary tax" which uses a tax formula that includes key variables in worldwide operations. While the tax is applied equally to both U.S. and foreign-owned companies, its impact tends to be greater on foreign companies. Any spread of this type of tax system to other states could have a major negative effect on the investment climate in the United States. In addition, the example of the U.S. use of unitary taxation could invite other national jurisdictions to follow a similar policy that would affect the investments abroad and the returns from them to American shareholders.

Conclusions

Investment issues will probably continue to remain a sensitive area or bilateral U.S.-Canadian relations. There is a fundamental difference between the two countries in the role that government plays in the national and local economies (Malmgren/Drouin, op.cit.). This, plus the relatively high degree of foreign ownership in Canada, means that the two countries will see foreign direct investment policy from different perspectives.

Nevertheless, investment issues need not be negative elements in bilateral relations. Both countries recognize the costs or policy conflict and the benefits of cooperation. Complaints by American businessmen about the FIRA have recently receded. In the trade field, consideration is being given in Canada to the development of proposals for bilateral trade agreements on a sectoral basis.

Both Canada and the United States have experienced the adverse impact of the global recession, the attendant liquidity crisis in the LDCs, the new competition coming from developing countries and the threat of protectionism. If we are to adjust to these forces and get back on a path of sustained noninflationary economic growth, we will need to accomplish, at the minimum, two tasks. First, we will have to maintain an open system of trade. Sectoral or other forms of trade liberalization may be able to contribute to the momentum necessary to avoid a backsliding to a repetition of the events of the 1930s. Second, we need to ensure the growth

of both domestic and foreign investment. Foreign investment is an important supplemental source of capital and technology for both of our countries. It is vital to the adjustment of our economies to the challenges of the intensified global trade competition. Thus, just as there is a need for bilateral and multilateral cooperation in the field of trade, so is there a similar need to establish a positive cooperative relationship among countries in the investment area. Leaving doubts about our ability to cooperate, despite our differences, in the minds or the world's investors will have substantial negative economic consequences on the levels of both foreign and domestic investment. I am increasingly optimistic that publics and governments will (at least by the sad lessons of experience if not foresight) appreciate the gains to be made and will work together accordingly.

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TABLE 1

Average Annual Flows
of Foreign Direct Investment To and From Canada*

1960 - 1982
(C$ millions)

	(1) Foreign Direct Investment in Canada	(2) Canadian Direct Investment Abroad	(3) [(1) - (2)]
1960-1964	$ 457	$ 93	$ 364
1965-1969	665	170	495
1970-1974	824	505	320
1975-1979	332	1,349	- 1,017
1980-1982	- 1,675	3,417	- 5,092

SOURCE: Statistics Canada - Quarterly Estimates of the Canadian Balance of International Payments

*NOTE: Excludes reinvested earnings

TABLE 2

Net Flows of U.S. Foreign Direct Investment Abroad
(1960 - 1982)
($ millions)

	Total	Canada	Canadian % of Total
1960-1964	$ 2,543	$ 758	29.81%
1965-1969	4,723	1,388	29.39
1970-1974	8,397	1,922	22.89
1975-1979	15,556	2,378	15.29
1980	27,720	3,750	13.53
1981	9,680	- 761	--
1982	- 3,008	- 1,313	--

*Includes reinvested earnings

SOURCE: Calculated from Bureau of Economic Analysis, Department of Commerce, Selected Data... 1950-1976, August, 1983 Survey of Current Business

TABLE 3

U.S. Direct Investment in Canada

1960 - 1962

(US$ Millions)

	Total Flows of Direct Investment 1/	Reinvested Earnings	Reinvested Earnings as % of Total Flows
1960-1964	$ 758	$ 412	54.35%
1965-1969	1,388	731	52.67
1970-1974	1,922	1,436	74.71
1975-1979	2,337	2,212	94.65
1980	3,750	3,589	95.71
1981	- 761	1,920	--
1982	-1,313	812	--

1/ Flows of direct investment equal to equity and intercompany accounts plus reinvested earnings.

SOURCE: Survey of Current Business, U.S. Department of Commerce

TABLE 4

Selected Countries with Significant Occurrences of Investment Performance Requirements

Country	Local Content and Exportation	Equity Participation	Technology Transfer	U.S. Foreign Direct Investment Position 1981-(US$ Millions)
Argentina	X	X		$ 2,735
Australia	X	X		8,779
Brazil	X	X	X	8,253
Canada	X	X	X	46,957
Colombia	X	X		1,178
Egypt	X	X		1,082
France	X		X	9,102
India	X	X	X	431
Indonesia	X	X		1,861
Malaysia	X	X	X	849
Mexico	X	X	X	6,962
Morocco	X	X		42
Nigeria		X		218
Saudi Arabia		X		580
South Korea	X	X		778
Spain	X	X		2,887
Taiwan	X			574
Turkey	X		X	210
Venezuela	X	X		2,175
				$ 95,653

• Sources: LICIT 1981; Robinson 1983; U.S. Department of Commerce 1981; Conference Board 1983; USTP 1983

TABLE 5

Total Flows of U.S. Foreign Direct Investment
1960-1982
(US $ Millions)

	(1) U.S. Direct Investment Abroad 1/	(2) Foreign Direct Investment in The U.S. 1/	(3) Net [(2) - (1)]
1960	$ 2,940	$ 315	$ - 2,625
1965	5,011	415	- 4,596
1970	7,590	1,464	- 6,126
1971	7,618	367	- 7,251
1972	7,747	949	- 6,798
1973	11,353	2,800	- 8,553
1974	9,052	4,760	- 4,292
1975	14,244	2,603	-11,641
1976	11,949	4,347	- 7,602
1977	11,890	3,728	- 8,162
1978	16,056	7,897	- 8,159
1979	25,222	11,877	-13,345
1980	19,238	13,666	- 5,572
1981	9,680	21,998	12,318
1982	-3,008	10,390	13,398

SOURCE: Survey of Current Business
U.S. Department of Commerce

1/ Includes reinvested earnings

TABLE 6

Inward Direct Investment Flows

Percentage distribution among 13 OECD countries

	1961-67	1968-73	1974-78
Canada	16.2	12.1	3.2
United States	2.6	11.4	26.7
Japan	2.0	1.7	1.2
Australia	15.6	12.9	9.5(1)
Belgium	4.5(2)	6.1	9.4
France	8.2	8.2	15.2
Germany	21.3	16.4	14.7
Italy	11.5	8.3	5.0
Netherlands	4.7	8.5	6.0
Sweden	2.4	1.7	0.5(3)
United Kingdom	9.7	7.4	6.1
Spain	2.7	3.7	3.7
Norway	0.8	1.4	4.1

1) From 1974 to 1976
2) From 1965
3) From 1974 to 1977

Source: International Investment and Multinational Enterprises: Recent International Direct Investment Trends, OECD, Paris, 1981, p.41.

DISCUSSANT'S REMARKS

ALAN V. DEARDORFF
THE UNIVERSITY OF MICHIGAN

Some Theoretical Thoughts on Investment Performance Requirements

by

Alan V. Deardorff

The University of Michigan

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Some Theoretical Thoughts on Investment Performance Requirements

by

Alan V. Deardorff

The University of Michigan

As I have heard and read about various investment performance requirements, particularly those used in Canada, I have been intrigued by the implicit acceptance of the views, apparently held by the governments involved, that such requirements are beneficial to the host country and harmful to the home country from which the investments originate. Both of these effects may in fact be valid, but it surprises me to see so little discussion of how these requirements affect the countries involved. As I have thought about it, it is not at all obvious that such policies are inappropriate from a global point of view; nor is it clear why they should be expected to help the country in which the investment takes place. As always for problems of this kind, the benefits and costs of the policies depend on the context in which they are used, as well as, in this case, on the particular form that the policies take. In my discussion I will touch on several situations in which investment performance requirements may make sense, and some other situations in which they apparently do not. None of this is conclusive, of course, but I hope it will direct the discussion towards finding out what is being accomplished by these requirements, so that ultimately we will be able to understand whether they really are the nefarious acts that they are so often made out to be.

That the issue may not be clear-cut should not be surprising, based on what we know from the theory of international trade. On the one hand, we know that any interference in free markets -- and a performance requirement is certainly such an interference -- in its own right constitutes a distortion and lowers welfare somewhere, either at home or abroad or both. On the other hand, we know that if other distortions are already present -- and they inevitably are -- then an additional distortion may be beneficial to all. Thus, in the theory of the second best, we are led to look for reasons for using a policy that distorts the market, these reasons being other distortions that the new policy may be able partially to undo. The lesson is not that anything goes; second best arguments for market intervention require that the distortions be quantified and the policies be calibrated carefully to avoid making matters even worse. Rather the lesson is that one cannot justly condemn any policy on the basis of its own effects alone. One must look instead at the specific problem that the policy is intended to help solve, and evaluate it in that context.

As a first example, consider the effects of a local content requirement applied to an inflow of investment from abroad. Such a requirement certainly does distort the input choices of investing firms (or, at the very least, distorts the selection among potential investors in favor of those who would rely heavily on domestic inputs anyway). Were such a policy used in a context of otherwise perfectly free trade and capital movements, it would surely reduce welfare, at home if not abroad.

But suppose that the context is not one of free trade, but rather of

protection. Suppose in particular that for whatever reason there are tariffs on final goods, but not on raw materials, intermediate goods, or semi-processed goods. If capital is at all free to move internationally, then it will seek to bypass the tariff on final goods by setting up minimal plants for final processing behind the tariff wall. As a result, there will be an inflow of foreign investment, but the input choices of the investing firms will be distorted by the tariff against the use of domestic inputs. In this situation it may be that a local content requirement may serve primarily to correct the distortion of input choices caused by the tariff, and thus have largely beneficial effects.

Admittedly this argument is somewhat suspect, since the choice of least cost inputs by the firms, wherever they are located, is not on the face of it distorted by a tariff on what they produce. And in addition we have the usual caveat that the first best policy action would be to remove the tariff itself. But suppose that we accept that there is in turn some valid reason for the tariff. Perhaps it is itself a second best policy for raising the domestic price in an industry to offset some other distortion. Perhaps it is the only politically acceptable way of pacifying the firms in a domestic industry that is threatened by import competition. Or perhaps it is being used on optimal-tariff grounds as a way of improving the terms of trade.

In any of these cases and others, an inflow of foreign investment that brings in only a small final stage of production or processing and leaves most value added taking place abroad, serves to undermine to a large extent the intent of the tariff, whatever it was. If enough firms move in to replace imports, then the tariff becomes redundant, and the domestic price in the industry rises by only the small amount of the increased cost of the domestic value added. The new subsidiaries provide just as much of a threat to previously existing domestic firms as did the imports, and they offset this threat only slightly for workers in the industry by providing a small amount of employment. As for the terms of trade, the country as a whole now pays somewhat <u>more</u> for the goods in question, since their price goes up by the increased cost of domestic value added, and none of this returns to the domestic government as tariff revenue.

Most of these adverse effects of foreign investment -- adverse, that is, in terms of what the tariff was trying to achieve -- can be removed by a local content requirement. The more value added must be installed domestically, the more the price in the industry will remain near the level set by the tariff, the less will domestic competitors be undercut, and the more jobs will be available in any case in the foreign owned firms and their domestic suppliers. Only the terms of trade effects continue to be adverse, since the real cost of the good to the country is raised even more. Thus, by and large it seems that one can make a case for a local content requirement as a supplement to a tariff for many of the situations in which the tariff itself might be viewed as legitimate.

There is another example that I find quite interesting in which a strong case can be made for an investment performance requirement of a particular sort. This arises when the investment itself is subsidized and there is a second best argument in which the requirement offsets the distorting effect of the subsidy. Note first, though, that I do not mean to suggest the use of investment performance requirements as a way to offset completely the

subsidizing effect of a subsidy. It is certainly true that any of these requirements, if sufficiently onerous, could wipe out any advantage provided to foreign investment by a subsidy and might stem the flow of investment completely. I take it though that this would not be done, at least intentionally, since one might then just as well omit the subsidy in the first place. Thus what I intend is to identify an additional distorting effect of a subsidy, one that extends beyond its obvious effect as a stimulus to investment, and argue that some form of investment performance requirement might offset this secondary and presumably unintended distortion.

Suppose then that a valid reason exists for providing an incentive for industry to move into the host country. Many such reasons are possible, but for concreteness suppose that uncertainties about the domestic markets and political environment make foreign investors more wary of locating plants in the domestic market than the host country government knows to be warranted. Here a subsidy to locating in the country is appropriate. Unfortunately, a subsidy to location per se is probably impossible, since it fails to distinguish among investors on the basis of their size. Thus, a more likely tool is a subsidy to investment -- a subsidy, that is, that is geared to the cost of the capital that is installed within the country. An obvious example of this would be a subsidized loan to the firm making the investment.

The trouble with a capital subsidy, though, is that in addition to influencing location of production in the desired direction, it also distorts the choice of factor proportions between capital and labor. Unless no such choice is possible, unless, that is, production requires the use of capital and labor in immutably fixed proportions, an investment subsidy will cause investing firms to select more capital intensive techniques of production than would minimize costs if they were paying the true cost of capital. There is a loss of efficiency as a result that is borne by the host country. But it shows up even more clearly in the host country labor market, where the inflow of investment fails to provide as much of a stimulus to employment as it ought to.

In this situation one might recommend an additional subsidy to the use of labor, to match the one that applies to capital. But while an investment subsidy can conveniently be made in the politically expedient form of a one-and-for-all payment or a subsidized loan, a subsidy to labor seems to require an ongoing program of wage supplements that are unlikely to be acceptable. Therefore as an alternative policy one might consider the use of an investment performance requirement that mandates the use of particular amounts of labor per unit of capacity. If this required ratio of labor to capital is selected correctly as representing the least cost combination of inputs at undistorted factor prices, then the effect of this requirement is to restore the optimal input choice without altogether undermining the subsidy. Note that while the investing firm will find itself forced to employ a more expensive combination of factors than it would like, given the low cost it is paying for capital, it still is enjoying lower costs than would have been the case without the subsidy, and the subsidy is still effective. Thus this particular form of investment performance requirement -- a labor content requirement in this case -- can be justified as offsetting an undesirable distorting effect of an investment subsidy without undermining the stimulus to foreign investment that the subsidy presumably is intended to achieve.

These two examples of second best arguments for investment performance requirements do not extend, as far as I can see, to one of the more familiar forms of these requirements, the export requirement. I have given some thought to this issue, trying to find some rationale for the use of export requirements within the framework of conventional models of international trade, and I have not been notably successful. Let me tell you what I found, even though, as you will see, my thinking on this issue has mainly left me dissatisfied with the models themselves.

First of all, without some distortions in the economy, an export requirement would seem to have no effect at all. The reason is that, with free trade it really does not matter whether an individual seller sells on the domestic market or on the foreign market; goods will find their way through the markets in any case to the same demanders. For example, if foreign investors into what is already the export industry are required to export, they will only do what they or some other firm would have done anyway. If, on the other hand, the requirement applies to investors in an import competing industry, one will find the seemingly perverse result of exports in that industry arising. But with free trade, these will simply be matched by greater imports of the same goods and the net flow of trade will be unaltered. Thus without some distortions, or at least some impediments to trade, export requirements are effectively meaningless.

I have tried looking therefore at models in which trade impediments do exist and in which export requirements can play some role. These are not hard to find. Consider, for example, a model in which capital and land are specific to two industries with labor mobile between them. Capital is used in the import competing sector and, by means of a tariff, has its rate of return raised above what it would otherwise be -- above, let us say, that which prevails abroad. If capital can move internationally, it will flow into this country, depressing the return to capital and raising both the wage and the return to land. If for some reason one wanted to prevent this from happening, an export requirement would indeed do the job.

If foreign investors were required to sell some fraction, say half, of the product as exports, they would not be able to achieve the same high rate of return as their domestic competitors. In essence they would be selling for an average price half way between the high tariff-inclusive price on the domestic market and the lower world price. Thus their inflow of capital would stop short of depressing the rate of return to domestic capital all the way to the world level.

The trouble with this argument, it seems to me, is not that it would not work, but that it is not necessary. If one wants to prevent domestic capital from having to compete on equal terms with foreign capital, one does not need to provide a handicap to the operations of foreign capital. One could simply exclude it altogether. As far as I can see, an export requirement in this model is exactly equivalent, in terms of its effects on factor prices and factor allocations, to a simpler tax or quantitative restriction on the inflow of capital itself. Since the latter would also avoid the artificial and presumably expensive need to export and import the same commodity, I would think it should be preferred. Thus I cannot find, in this sort of a model, a plausible explanation for export requirements.

I thought for a while that a rationale for export requirements might be

found by looking at departures from perfect competiton. There have been many recent contributions to the literature of international trade theory that have focused on various noncompetitive models, and many of these have found novel arguments for uses of trade policy in ways that we normally condemn. Therefore, I thought, and in a sense I still believe, that imperfect competition would provide a suitably mixed up environment to make export requirements appear as rational policy.

Consider, for example, a situation in which a good is available only from a foreign monopolist which must, because of transport costs, invest in the domestic market in order to make it available domestically. The technology involves decreasing costs, up to a point, however, and the domestic market is not large enough to support a minimally efficient plant. My thought was that, by requiring the firm to export part of what it produces domestically, you could force it to expand production and thus lower costs and prices charged on the domestic market. I still think this is an intriguing idea, but unfortunately it does not work. As I have analyzed the problem, I find that the export requirement always leads to a higher price on the domestic market. The reason is that the cost of exporting at a loss (it has to be at a loss or the requirement would be satisfied voluntarily) must be figured into the cost of increasing sales on the domestic market. It turns out that this cost increase always more than matches any cost saving that can be achieved by increasing scale.

Another possibility that was suggested in this analysis was that an export requirement might help to erode the monopoly power of the foreign firm. If demand on the world market is more elastic than at home, then by requiring that domestic sales be matched in some proportion by exports one might increase the effective elasticity of demand facing the foreign firm in its decision as to how much to sell domestically. This increased elasticity, as is well known, should reduce the markup of the monopolist and permit an expansion of sales. Unfortunately, this argument too seems to fail when I try to draw it out of a simple model. Again, the increased cost of selling exports at a loss apparently outweighs any benefit from a reduced markup.

I have not given up completely on the possibility that imperfect competition might provide a role for an export requirement. My first argument might work if the export requirement were not pegged to domestic sales, but instead set at a fixed quantity per plant. And the second argument might be salvaged if the export requirement were combined with some sort of subsidy. But in either case I would suspect that the basic inefficiency of requiring exports from an industry in which there is not a comparative advantage will assure that any small gain that might be achieved could be surpassed by some other more direct and simpler policy. A direct tax on the profits of the monopolist, if these profits can be identified, for example, or a tax on pricing the product above some minimum level, would both be likely to be socially preferable policies.

Having said all this, I would like to conclude by admitting my own sense of dissatisfaction with what I have said. I feel that I may have missed the point. I have been looking for reasons for investment performance requirements within models of trade that may already have abstracted from what the true reasons really are. This is not the first time I have felt this, but I feel it especially strongly here.

Intuitively it seems clear that export requirements -- and to a lesser extent the other peformance requirements that so many countries use -- are intended quite simply as a way of acquiring foreign exchange. Why does a country want foreign exchange? In order to be able to import. Trade theory typically does not speak of foreign exchange, but does certainly acknowledge the fact that a country cannot import if it does not export. In fact, without foreign exchange and financial assets generally, the constraint of the trade balance is totally binding. Nonetheless, we do not normally model exports as imposing a binding constraint on imports. The reason is that, for small countries like Canada especially, we expect traders to be price takers in both the markets for imports and for exports, able to buy and sell all they desire at given world prices. The constraint on imports is not what a country <u>can</u> export but what it <u>wants to</u> export. As such, no artificial increase in the amount of exports can increase welfare.

The trouble is, it seems to me, that countries <u>do</u> face constraints on exports, at least in many of the world markets in which they participate. Particularly in manufactured goods, countries, like the individuals and firms within them, would like to sell more if they could; they just can't. The skills in marketing their products that are so important for many firms are also important for the countries from which they operate, since their ability to sell abroad and acquire foreign exchange limits the ability of the country as a whole to import and thus gain from trade. Conventional trade theory and even most of the more modern work on imperfect competition and international trade do not allow for the possibility that many markets exist quite naturally in a chronic state of excess supply. Most sellers in the market would sell more if they could, and they devote a good deal of time and resources to trying to accomplish this. Without a view of the trading world that acknowledges this, I doubt that we can ever make very useful sense of such practices as export requirements applied to foreign investment.

If a country's imports are constrained by her exports, and these are in turn constrained not by domestic supply but by foreign demand, then it makes sense to seek the help of successful foreign corporations that have already acquired a share of world markets. Indeed, an exchange of markets is likely to be possible, since the corporations, in spite of their success, are also fundamentally constrained by the demands they face. Thus, it may be both possible and desirable for a country to exchange access to its domestic market for the corporation's assistance in penetrating markets abroad. The simplest way to do this may be by attaching an export requirement to any permit to invest in the domestic market.

I have no idea whether this sort of an argument can be made rigorous, since it goes well beyond the scope of economic theory as I know it. Unless and until it is, I would not want to accept it as anything more than the most tentative of suggestions. Still I believe that something like this argument has to be considered if we are to understand and evaluate the policies we see being implemented in the real world.

DISCUSSANT'S REMARKS

ROBERT G. LOGAN
IBM CANADA LIMITED

U.S./Canadian Investment Frictions

November 18, 1983

Robert G. Logan
IBM Canada Ltd.

U.S./Canadian Investment Frictions

It is a pleasure to be here this afternoon, to share with you my views concerning U.S. - Canadian investment frictions.

Working for a large American multinational in Canada provides me with a unique view of this contentious bilateral issue. Furthermore, because we are moving increasingly into an information society and IBM is a dominant figure in the information technology industry, I believe it also provides me with an added perspective on some future prospects for this issue.

There is little doubt that I fundamentally support the position taken by Harvey Bale in the paper he presented today. Perhaps the point I am most in agreement with is the change he made in the title from "U.S./ Canadian Investment Frictions" to "Investment Frictions and Opportunities in Bilateral U.S./Canadian Trade Relations".

Indeed, I believe there are many opportunities developing in both countries as our respective economies move increasingly towards what some have called the Information Age. Given a world where interdependencies and international competition will dramatically increase, and in which information has no nationality, our respective governments must re-examine their approaches to national and international policy making.

During the recent Canada Tomorrow Conference held in Ottawa a few weeks ago, a major theme was the international character of Canada's markets. Opinion leaders are increasingly agreeing that Canada's primary business objective must be the development of world competitive enterprises. To achieve this objective, Canada needs to attract capital investment, welcome technology and utilize our strengths in human resources.

Specifically, Canada's attitude toward foreign investment will be a deciding factor if we are to realize the benefits of the Information Age. The building blocks needed for an information society require substantial investments in both technological development and skills training. To be able to attract the necessary investment, Canada must create and maintain a positive and friendly investment climate. Government policies must be predictable and stable enough to provide investors with the degree of confidence necessary to convince them that it would be worth- while to make long term investments in Canada. Furthermore, because it is unlikely that we will be able to internally generate investment on the scale necessary to support our future technological development, we will have to re-examine our attitudes toward foreign investment.

As you are aware, foreign capital has historically had a very important place in Canadian economic development. Canada has relied heavily on the process of international investment to finance the development of its infrastructure, resources and manufacturing sector. However, the presence of strong economic nationalist sentiments within the country has often hampered the promotion of foreign investment in the economy.

When public opinion polls ask more detailed questions, however, a different result appears. Canadians clearly recognize that foreign investment has many benefits including jobs, technology transfer and access to foreign markets. When asked if Canada should limit foreign investment if it means giving up the benefits, Canadians say "no". Specifically, Canadians are unwilling to limit foreign investment if it means fewer jobs.

When it deals with foreign investment, government policy will have to recognize the role of the multinational and the value-added it can bring to our economy through the transfer of technology. This is starting to happen.

The federal government's recent report on trade policy clearly states that the encouragement of new investment will be one of the major challenges facing the government as the economic recovery takes hold.

But what about the responsibilities of multinationals in Canada? Is it not reasonable to expect some level of good corporate citizenship?

Many of us in the multinational business community would be pleased if we were judged by our performance and not by our ownership. We also believe that any performance criteria should apply equally to Canadian and foreign-owned companies. I think we would stand up quite well to the comparison.

Having stated this, what constitutes performance criteria? At IBM Canada we pursue the following:

1. Canadian management - IBM has a longstanding policy that each subsidiary should be managed, staffed and operated by the nationals of each country in which it operates. Virtually all of our employees are Canadians and all of our Officers are Canadian.
2. Mission specialization - The subsidiaries should specialize in the production of a limited number of products for the international market. This permits the subsidiary to achieve the expertise and economies of scale needed to compete not only in its own markets but internationally as well.
3. Export promotion - Rationalization has enabled us to dramatically increase our exports, which in turn has allowed IBM to make a significant contribution to Canada's international trade in information technology.
4. Canadian procurement - We have a policy of locating and developing local sources of supply. In our manufacturing operations particularly, the company relies on many Canadian firms for supplies, sub-assemblies and tools. Furthermore, we act as an international procurement agent for the corporation as a whole.

5. Research and development - Given the importance of product development to maintain international competitiveness, IBM Canada operates one of the top private sector R&D facilities in Canada. The emphasis in this lab has been in the development of end user application software.

6. Technology Transfer - We are committed to providing Canadians with the most advanced technology available in the world. We are engaged in developing Canada's most valuable resource - its people. Every IBM employee completes an average of ten days of education annually and we place a premium on the education of our customers. We operate the equivalent of a medium sized university in Ontario. As well, we have entered into several co-operative programs with leading educational institutions throughout the country to develop a wide variety of leading edge computer applications in an effort to introduce a maximum number of students to the application of information technology.

7. Regional Development - Through our national telecommunications network we provide an equal level of support and service to locations across Canada.

8. Participation in Canadian Social and Cultural Life - We are committed to full participation in and support for cultural and community programs throughout the country. In addition, to promote our national culture, we sponsor major national cultural performances across Canada.

We believe that each of these performance criteria are in accordance with Canada's national goals for social and economic development. It is critical for Canada's development that all businesses, including foreign multinationals, contribute to the achievement of national goals.

Furthermore, all levels of government must be committed to the same national goals. Recently, I have witnessed several occurrences of both the federal and provincial governments promoting Canadian content in certain procurement situations. This consideration of product content runs directly contrary to specialized missions and indeed discourages them in favour of inefficient branch plant operations. As well, certain provincial governments have carried the notion of Canadian content one step further and are requesting provincial content in certain tenders. Clearly, if this continues we will all witness a severe balkanization of the Canadian economy and achievement of national economic goals will most certainly not be met.

This issue of government intervention in the procurement process brings me to Mr. Bales' conclusion that there is a fundamental difference between Canada and the U.S. in the role that governments play in the national and local economies. This fundamental difference is the underlying cause of the friction that has arisen between the governments over investment issues.

As I often attempt to explain to my IBM U.S. counterparts, Canadians are pragmatists. Because we have not had the pools of private capital available to meet our investment needs we have turned to our governments to finance and operate some of our largest capital projects. Canadians, by and large, accept this intervention in the economy and expect business and government to work together to optimize this arrangement. However, in the upcoming decade we will be faced with some new challenges.

To restate an earlier point, some of these challenges that must be met in an evolving Information Age will include:

1. a full understanding of the strategic implications of an information society
2. accepting the fact that the rate of change will accelerate
3. adopting flexible public policy strategies
4. providing an economic, political and social environment which is supportive of the wealth generating institutions in its society.

In this context, many of our policies, programs and initiatives in place today will have to be significantly modified. For example, if Canada succeeds in getting the benefits which a maturing Information Age will offer, by acquiring capital investment wherever it is available and technology from wherever it exists, we will be able to produce goods and services in greater quantity than will be needed to satisfy our national markets.

The question therefore arises, can we afford to isolate ourselves from the world economy? To again reference the federal government's report on trade policy: "Canada is crucially dependent on trade to maintain the current standard of living". I doubt if pragmatic Canadians would agree with isolationism for very long. Indeed, our economy will become increasingly dependent on having easy access to international markets. It follows that Canada will have to advocate the removal of barriers to trade and investment not only with respect to goods but also with respect to services and technology. Moreover, Canada will have to adhere to the principal of national treatment with our trading partners. Similarly, to be consistent and to avoid the possibility of retaliation, Canada will not be able to have one set of rules for its national firms and a different set of rules for all others.

Canada's attitude towards international trade and investment will be a major cornerstone in the success or failure of our economic well being and must be a prime focus throughout all levels and functions of government. We will need to do a much better job of co-ordinating our national policies with our international policies, to ensure that the two can be made to work in harmony.

Thank you.

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